"Striking the right balance in policies and institutions in the euro area"
Speech by Klaas Knot,
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Good morning all,
Thank you for inviting me here to speak about economic policy in the euro area in the spirit of Mark Twain. In the instructions to this Twain Talk, the organizers asked me not to focus too much on so-called “known knowns”. This is an easy task for a central banker in current times.

In recent years, we have faced many unprecedented policy challenges. And we have had to implement policies that reached well beyond what we considered conventional before the crisis. Yet, by doing so, central banks have played an important role in stabilizing the economy. As a consequence, we now face a much improved economic environment.

Today, I will give you my views on the way forward for the euro area against the backdrop of this improved outlook. Acknowledging there are still many unknowns along the way, I will stress that the time has come to rebalance our economic policies. Away from non-standard monetary policies to addressing the structural and institutional factors that have been holding back growth.

Monetary policy during the crisis
First, however, let me quickly talk you through how we got to where we are now. Since the onset of the financial crisis in 2008, it has not been an easy ride for the euro area.

We have seen drastic adjustments in three different macroeconomic sectors:
The financial sector has had to repair its balance sheets. The private sector has been in a deleveraging mode for nearly a decade. And governments have also had to make major fiscal adjustments. These deleveraging efforts have been holding back growth.

As a result, over the past decade, economic policy in the euro area has mainly involved crisis management and stimulating demand. Partly owing to limited fiscal space in many euro area countries, monetary policy at times became the only game in town. Even after policy rates had been brought down to zero, central banks have proved creative in finding ways to fight the economic problems caused by the crisis.

In this environment, the ECB had to take far-reaching measures. We have substantially lowered our main policy rates, even into negative territory, to stimulate consumption and investment. Moreover, several non-standard monetary policy measures were taken to bolster the transmission of low policy rates in the face of persisting market tensions.

In 2015 there were serious concerns that the euro area could slide into a deflationary spiral, a self-reinforcing spiral of falling prices and output. Against this backdrop, in 2015 the ECB introduced quantitative easing, QE, to provide further monetary policy accommodation. By lowering long-term interest rates, QE has helped to further loosen financing conditions for households and businesses. This in turn should have a positive impact on their spending decisions and, ultimately, on inflation.

Rebalancing necessity, effectiveness and risks
When deciding on monetary policy measures such as QE, decision-makers typically assess policy options along three dimensions: necessity, effectiveness and side effects.

Since these guiding parameters change over time, continuous monitoring and reassessment are needed. And this is exactly what we are reconsidering right now when reflecting on how to proceed with our QE-program beyond 2017. Against this backdrop, let me discuss in a bit more detail how I reflect on the dimension of necessity of at the current juncture. A dimension along which the considerations have changed quite significantly since we first started with QE in early 2015. Allow me to highlight four specific elements.

First, financing conditions in the euro area are currently very accommodative and highly supportive to growth.This is largely a consequence of previous ECB monetary policy measures.

Second, financial fragmentation between euro area countries has been reduced. This is reflected in a more homogenous transmission of monetary policy decisions across jurisdictions compared to what we observed during the crisis.

Third, the economic outlook has improved significantly. Specifically, we have now registered twelve quarters of reflationary growth. In other words, three years of economic growth above potential. Finally, and most importantly, against the backdrop of an increasingly reflationary environment, the tail risk of a deflationary spiral is no longer imminent. Consequently, the main rationale for central bank asset purchases has disappeared.

To summarize, assuming the robust economic developments continue we can be confident that inflation will return to levels consistent with our aim of below but close to 2% over the medium-term. In this environment the necessity of QE is clearly less obvious. At the same time, some may be concerned with the challenges of normalizing monetary policy. However, while there will indeed be challenges along the way, I see no reason to be overly dramatic.

Let me discuss some considerations that are often overlooked by commentators.

First, even if we no longer expand our QE-program, we are still committed to a reinvestment policy. This reinvestment policy implies that the ECB will maintain a large portfolio of assets on its balance sheet for a pronounced period of time. Alongside low policy rates this will ensure that financial conditions will remain accommodative even when the net asset purchases have been reduced to zero. This way monetary policy will continue to support the economy and a gradual increase of inflation to levels consistent with our aim over the medium-term.

Second, some have looked at the recent appreciation of the exchange rate of the euro as a source of concern. And indeed, excessive exchange rate volatility and overshooting can be detrimental to economic growth and price stability. However, it is often overlooked that exchange rates move endogenously in response to changes in the economic outlook and market sentiment. For example, the recent appreciation of the euro area reflects to an important extent a more benign assessment of the economic outlook vis-à-vis the rest of the world. And safe-haven capital inflows have also increased in response to increased political uncertainty in other major economies.

Through this lens, the appreciation of the euro should be considered a reflection of the relative strength and stability of the euro area economy. A clear indicator of the factors that underlie the reduced necessity of continued asset purchases that I have outlined earlier. All supporting the call for a gradual but decisive rebalancing away from non-standard towards traditional instruments of monetary policy.

Tilting the broader policy mix

Thus, monetary policy has played and will continue to play its part in helping to keep the economy at solid footing. By itself, however, monetary policy is not enough to achieve and maintain sustainable economic growth. Indeed, structural factors play a key role in the low prospects for growth. Calling for yet another reorientation of macroeconomic policies. Let me explain this in more detail in the remainder of this talk.

Many countries have failed to adapt to the changing environment in recent decades, most importantly in terms of technological progress and globalisation. In addition, the monetary union removed the exchange rate as an adjustment mechanism for member states. By 1999 it was clear that several member states needed structural reforms to strengthen alternative adjustment mechanisms, like wage and price flexibility. In practise, however, structural differences between EMU countries have not lessened, unlike in the rest of the EU. The lack of structural convergence has had important real effects. Since 1999, income differences between the initial EMU member states have not been reduced.

The structural nature of the disappointing growth in the EMU calls for structural reforms. These reforms should expand the growth potential and adaptability of member states. Measures to this end could focus on product markets, including the liberalization of the service sector. In many countries the quality of institutions also needs improvement. This includes the efficiency of the judicial system in settling disputes, protecting property rights and dealing with non-performing loans. The OECD estimates that the adoption of best practices in areas like these could increase GDP by four to seven percent.

Strenghtening EMU further

Every country faces its own particular challenges. In addition, there are some common elements in the problems faced by euro area countries. Indeed, part of the European growth problem is related to design flaws in the monetary union. Much has already been done to tackle them. I'm referring to:

- the strengthening of the European fiscal rules and the introduction of new rules aimed at preventing macroeconomic imbalances;
- Launching the European Stability Mechanism, the ESM, to provide financial assistance to countries in difficulties;
- And finally, establishing the banking union to unravel the sovereign-bank nexus.

While these measures have reduced the risks of severe financial turbulence, the EMU could still do with additional improvements.

First and foremost, we need a better balance between liability and control. Let me explain what I mean.

In the long run, a monetary union is only politically stable if the countries that are liable for certain risks, also have the means to control and mitigate these risks. The original EMU setup was thought to strike the right balance in this respect. Policy coordination was relatively mild, with the European fiscal rules as the most binding element. In return, Member States promised not to assume liability for other member states' debt, the so-called no-bailout clause. But during the sovereign debt crisis, adherence to the no-bailout clause proved too costly. Both public risk-sharing and coordination increased since then, in a move towards the upper right-hand quarter of the charts.

However, in practice the move has been larger in terms of risk sharing, than in terms of policy coordination. This is mainly because compliance with both new and existing rules is still lacking. Compliance with fiscal recommendations is reasonable in bad times when budget deficits are above 3%, but poor in good times when countries should balance their budgets. Compliance with the Macroeconomic Imbalances Procedure and the European Semester should also improve. Of the recommendations issued in 2015, only 4% were implemented with any substantial progress.

To improve the balance between liability and control, we therefore need to improve enforcement of the rules. This would help reduce the likelihood of new imbalances and future calls on European risk-sharing.

Secondly, the EMU would benefit from more private risk-sharing across borders. During the crisis, European governments used taxpayers' money to provide support. But private companies, investors and banks shared far fewer risks. Improving private risk-sharing would help reduce dependence on public risk-sharing. It could also help smooth idiosyncratic business cycle shocks, as appears to have been the case in the U.S. and Germany.

Does the answer lie in more integration?

Of course, the key question is: how do we further strengthen the EMU? It is often assumed that deeper European integration is the answer, for example by way of more binding policy coordination. Many also favor more public risk-sharing, such as the introduction of a European budgetary stabilization fund. Further European integration would indeed probably lead to a better functioning EMU. However, major steps forward are controversial, and may not be politically feasible in the current environment.

In countries like The Netherlands, controversy mostly centers around a further increase in public risk-sharing. The fundamental problem is that Member States still differ substantially in terms of adaptability, overall competitiveness and institutional quality. If starting positions differ so much, a stabilization fund might not result in ex-ante fair risk-sharing, but in a quasi-permanent one-way transfer system.

Therefore, any further increase in public risk-sharing is only desirable if it is accompanied by a significant risk reduction. This however requires a further transfer of sovereignty; a policy that is equally controversial in many Member States.

As a result, large leaps forward in integration are presently hard to conceive.

Given all the steps that have already been taken over the past years, I however believe that with a series of relatively small steps aimed at restoring the balance between liability and control we can already achieve a great deal of improvement.

Let me therefore conclude by mentioning four no-regret options. First, improve compliance with European fiscal and macro-economic rules, by simplifying and strengthening the rules.

Second, introduce some form of sovereign debt restructuring mechanism. In the future, it should be ensured that the public debt is sustainable before countries gain access to financial support.

Third, complete the banking union. Reducing systematic differences between banks from different Member States will pave the way for a European Deposit Insurance Scheme.

Finally, encourage private risk-sharing across borders via more robust financial integration.

Conclusion

Ladies and Gentlemen, allow me to conclude. Over the past decade, euro area policy making was mainly directed at short-term stabilization, with the ECB occupying an important role. But with the immediate economic crisis behind us, and with the economic outlook improving, we need a recalibration of euro area policy. The focus of policy makers should shift to the structural and institutional problems that are still holding back growth. This is where relatively small steps can make a big difference.

Or to quote Mark Twain:

“Continuous improvement is better than delayed perfection.”

Thank you for your attention.

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